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NO._____

IN THE

Supreme Court of the United States

OCTOBER TERM, 1941.

TERRY THOMPSON, ET AL., INDEPENDENT EXECUTORS OF THE ESTATE OF J. T. SNEED, JR., DECEASED,

Petitioners,

vs.

GUY HELVERING, COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Petition for Writ of Certiorari to the United States Circuit Court of Appeals for the Fifth Circuit.

Terry Thompson, Elizabeth Sneed Pool, L. G. Haile and H. C. Pipkin, Independent Executors of the Estate of J. T. Sneed, Jr., Deceased, pray that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Fifth Circuit entered in the above entitled cause on May 5, 1941, affirming a decision of the United States Board of Tax Appeals.

OPINIONS BELOW

The original opinion of the Circuit Court of Appeals (R. 86) is reported at 119 Fed. (2d) 767. It was amplified in an opinion on Motion for Rehearing (R. 104), reported in 121 Fed. (2d) 725. The opinion of the Board of Tax Appeals is reported in 40 B. T. A. 1136.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered May 5, 1941. (R. 95.) Petitioners' Motion for Rehearing, seasonably filed, was denied on July 17, 1941. (R. 106.) The jurisdiction of this Court is invoked under Section 240(a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

Can a portion of certain sums which Petitioners' decedent (Sneed) received in *1926*,[1] and of which he then and thereafter had unqualified ownership and possession, without obligation or liability to anyone, be treated as a part of his taxable income in *1936*, even if:

(a) The total sums received in *1926* were paid to Sneed as bonuses for various oil and gas leases which he made in that year on various portions of a ranch owned by him;

(b) He obtained in *1926* an allowance for percentage depletion with respect to all of these bonuses;

---

[1]Emphasis supplied throughout unless otherwise noted.

(c) Certain of these leases lapsed in *1936* without development upon the areas covered by the lapsed leases although the substantial mineral reserves underlying the lapsed-lease areas had been partially depleted by production from other wells on the ranch from which Sneed received royalty income; and

(d) The sum included in *1936* income represented the percentage depletion allowed with respect to the bonuses received in *1926* for the leases which so lapsed?

STATUTES

The pertinent statutes appear in the appendix.[2]

STATEMENT

Sneed owned a ranch in Moore County, Texas. (R. 44). Developments subsequent to his acquisition definitely established that the entire ranch was underlain with one continuous, highly productive gas stratum, and less regular oil deposits. (R. 25, 44, 49, 51.) Sneed made numerous commercial oil and gas leases on areas out of the ranch so that, by the end of 1926, it was all under lease (R. 45). All leases involved here were for a primary term of ten years and for so long thereafter as oil or gas was produced, with the customary royalties to the lessor. (R. 45.) Sneed received a cash bonus for each lease made. (R. 49.) These bonuses became Sneed's property, unconditionally and without liability or obligation to anyone, when he received them in 1926. (Cf. typical lease, R. 75.)

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[2]See pp. 49 to 51, infra.

Sneed reported the bonuses received in 1926 as a part of his gross income for that year. (R. 27.) He claimed, and ultimately obtained,[3] (30 B. T. A. 1121; 33 B. T. A. 478) allowances for depletion with respect to such bonuses upon the percentage of income basis.[4] (R. 25, 74.)

Between 1926 and 1936 extensive development was carried on by several of Sneed's lessees with the result that substantial quantities of oil and more than forty billion cubic feet of gas were produced and marketed from the ranch, Sneed receiving and reporting his ordinary royalties thereon. (R. 49, 71.) However, no wells were drilled upon twenty-six of the leased areas during the ten year primary term, so that these twenty-six leases lapsed in 1936. (R. 74.) Sneed made new leases upon the lapsed areas to other operators, receiving therefor cash bonuses which were reported as a part of his gross income. (R. 27, 74.) He claimed and was allowed percentage depletion with respect to these new bonuses. (R. 27, 74.)

The development and production during this ten year period demonstrated with absolute certainty, (and the Board found)[5] that every part of the ranch was originally underlain with a continuous gas stratum (R. 59, 62); that this gas content had been depleted through production (R. 59, 64); this depletion had resulted to a large extent from production through wells

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[3]In accordance with Herring v. Commissioner, 293 U. S. 322, decided while his appeal was pending.

[4]Sec. 214(a)(9) and Sec. 204(c)(2) of the Revenue Act of 1926. (R. 74.)

[5](R. 26, 27).

on other parts of the ranch from which Sneed had received, and reported for taxation, royalties (R. 26, 27, 71, 74); that the pressure or gas in the stratum underlying the entire ranch dropped during this ten year period from 430 pounds per square inch to a low of 280 pounds (R. 56, 57); the depletion on the twenty-six lapsed areas averaged 11% of the original reserves, varying from 2.7% to 28.9% (R. 58, 62); but this left ample reserves for commercial production under each of these twenty-six areas *which would be subsequently produced.* (R. 27, 59.)

Upon auditing Sneed's 1936 return, the Respondent determined that $38,720.62 (the amount allowed as depletion in 1926 with respect to the bonuses paid for the leases which lapsed in 1936) should be included in his income for 1936 as "restored depletion." (R. 14.)[6]

The basic theory of decision in the Court below was that the 1926 depletion allowances represented untaxed gross income received in 1926; that these allowances were made upon condition that, if the lessor's property was not subsequently depleted, the allowances were to be restored to income; and that, since the statute of limitations prevented correction being made in 1926, it was proper to treat the "untaxed income" as income for the year in which it was established that no depletion had been actually sustained by the lessor. (R. 89-94.) In determining whether there had been actual depletion within this ruling, the Court held that neither the actual depletion which Sneed's ranch prop-

[6]This amount was adjusted by stipulation to $33,528.07, but this correction has no bearing upon the issue presented here.

erty as a whole admittedly sustained during this ten year period, the reduction in reserves under each of the twenty-six areas occasioned primarily through production elsewhere on the ranch, nor the established fact that each of the twenty-six areas would actually produce subsequent to 1936, had any bearing upon the question. (R. 89-94.) Instead, the holding was that, in ascertaining whether actual depletion had been sustained, for the purpose of applying its rule, the Court would look only to the precise area covered by a particular lease, and would require that the depletion of that area occur through production from a well drilled on that area, during the term of that lease, regardless of the certainty of future production from, and depletion of, that precise area. (R. 88-92.)

The decision below was unanimous. (R. 86, 94.) But in a case[7] involving the same question, submitted at the same series of hearings, Judge Hutcheson, who did not sit in the Sneed case, filed a forceful dissenting opinion in which he stressed particularly the unfairness of the majority rule in its application to various lessor-lessee situations which frequently arise and in which he vigorously disagreed with the construction which the majority placed upon the Treasury Regulations.[8] For convenience, this dissenting opinion is reproduced in the appendix, infra, pages 55-60.

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[7]Crabb v. Commissioner, 119 Fed. (2d) 772, (5th C. C. A.).

[8]These regulations are set out and discussed in the accompanying brief at p. 25, infra.

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

(1) In holding that Sneed received income in 1936 in an amount equal to the 1926 allowances for percentage depletion, when oil and gas leases made in 1926 lapsed without production from the leased areas.

(2) In holding that taxing such amount as 1936 income was not contrary to the constitutional and statutory provisions defining income and requiring the calculation of taxable income upon an annual basis.

(3) In holding that Sneed took the 1926 depletion allowances upon condition that they be restored to income when and if it was determined that there would be no production from the particular lease for which the bonus was paid.

(4) In holding, in view of the undisputed fact that the gas reserves in each of the areas covered by the twenty-six leases had been actually depleted, that the amount of the 1926 depletion allowances should be included in Sneed's income in 1936.

(5) In holding, it being conclusively established that there would be production subsequent to 1936 from the twenty-six areas and the 1926 bonuses having been "income from the property," that the 1926 depletion allowances should be restored to income in 1936.

(6) In refusing to hold that Sneed's entire ranch was one "property," in applying the principle that bonus depletion allowances cannot be restored if the "property" has been depleted during the life of the lease.

REASONS FOR GRANTING THE WRIT

The writ should be granted because the basic holding of the Court below conflicts with controlling decisions of this Court and an applicable decision of the Second Circuit Court of Appeals; and because the Court below decided an important question of federal law which has not been, but which should be decided by this Court.

CONFLICTS

I.

The Court below said, in summation of the holding upon which the Petitioners base their claim of conflict:[9]

> "*But where the return is correct on the facts as they were when it was made, but occurrences in a later year alter the case, the adjustment is generally to be made in the latter year.* This does substantial justice, gives more stability to the annual tax settlements, escapes the complication of limitation statutes, and serves administrative convenience. This case comes within the latter rule."

This holding, the heart of the case, that the amount of an error made ten years previous became income in the year that the error was established, without the receipt or accrual in that year of anything and without the reduction of any liability, directly conflicts with

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[9]Here we assume, arguendo, that the Court below correctly held that the 1926 depletion allowances were improper, but we confidently assert and attempt to show in the attached brief, that these allowances were properly made.

the holdings of this Court and of other Circuit Courts of Appeal.

In *Guaranty Trust Company v. Commissioner*, 303 U. S. 493, this Court said (page 498):

> "Receipt of income, or accrual of the right to receive it within the tax year, is the test of taxability, * * *."

The Court below admitted, as everyone who examines the record must, that nothing was received by or accrued to Sneed in 1936. The fact that the leases terminated in *1936* does not bring Sneed's case within the rule of *Guaranty Trust Company v. Commissioner*, *supra*. The Court below correctly said on this point:

> "It is not a good reply that Sneed got back the leasehold interest in the land in 1936. If that be the ground of income, the value in 1936 of what he got back would be in question. And in truth he got nothing back; the lease simply perished according to its original terms."

Other decisions of the Court hold that income and deductions must accrue or be received or paid within the tax year before they can enter into the calculation of the taxable income for that year. A typical case is *Burnet v. Sanford & Brooks Company*, 282 U. S. 359, where it was said (page 363):

> "All the revenue acts which have been enacted since the adoption of the Sixteenth Amendment have uniformly assessed the tax on the basis of annual returns showing the net result of all the taxpayer's transactions during a fixed accounting period, either the calendar year, or, at the

option of the taxpayer, the particular fiscal year which he may adopt. * * *."

In *Burnet v. Thompson Oil & Gas Company*, 283 U. S. 301, it was said, at page 306:

> "The tax is an income tax for 1918, and in the absence of *express provision to the contrary*,[10] it is not to be supposed that the taxpayer is authorized to deduct from that year's income, depreciation, depletion, business losses, or other similar items attributable to other years."

A recent decision by the Second Circuit Court of Appeals, *Helvering v. Schine Chain Theatres, Inc.*, 121 Fed. (2d) 948, decided July 21, 1941, with which the decision below conflicts, is particularly pertinent because the Second Circuit case dealt with prepaid rentals for building leases which were not even reported as income in the year when they were received by the lessor for his unqualified use and disposition. For one such long term lease the lessor in 1929 received an initial payment of $440,753.46, no part of which was "under any circumstances (to) be returned to the tenant notwithstanding any termination of this lease for any reason whatsoever prior to the expiration by lapse of the term hereof."[11] The lessor reported in 1929 only an aliquot portion of the cash payment based upon the possible life of the lease, and followed the same practice through 1933. In 1933 the lease was cancelled in an insolvency proceeding. The Commissioner attempted to add to the lessor's 1933 income the unre-

[10]There are no such provisions applicable here.

[11]This is the exact situation as to all of the lease bonuses here involved.

ported balance of the initial payment. The Second Circuit Court of Appeals refused to permit this. After stating that:

> "* * * everyone now agrees that the payments in question were in fact income only in the year 1929 when they were received. The time had passed in 1933 to assess a deficiency for that year, and unless the Commissioner can succeed upon some theory of 'estoppel,' the unfortunate fact is that a very large sum will escape taxation."

the Court then held that, under the circumstances,[12] the taxpayer was not estopped to assert that funds which it had received, without limitation or liability in 1929, could not be taxed as income for 1933.

Under the opinion in the Court below, the question of estoppel would never have been reached. That Court would have taxed the item when "occurrences in a later year (had) alter(ed) the case." The bases of the two decisions thus fundamentally conflict.

All of the above is said in full recognition of the principle that taxable income can sometimes accrue when there is no actual receipt within the tax year, but there is a realization of an enhancement in wealth. *United States v. Kirby Lumber Company*, 284 U. S. 1, is such a case. There the Lumber Company's bonds were bought in and retired for less than the issuing price. In that case, liabilities were reduced and assets were freed from the charge theretofore against them. Somewhat similar situations arise when a bad debt

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[12]The controlling point on estoppel was that there was a disclosure, without misrepresentation, of all pertinent facts.

previously charged off is collected, an operating expense or tax previously considered in calculating taxable income is reduced, recouped or avoided, or reserves freed from an offsetting liability. In all of these cases there is either an actual receipt in the tax year or a reduction in an actual liability. Not one of these elements is present in this case. The bonus money became Sneed's, unqualifiedly, in 1926. He had no liability to anyone with respect to it. He received nothing in 1936, nothing then accrued to him, he was freed from no liability. There was nothing to meet this Court's requirement that receipt or accrual of income within the tax year "is the test of liability."

II.

The decision below conflicts with *Herring v. Commissioner*, 293 U. S. 322. The Herring case recognized and held, in substance, that the depletion section of taxing statutes grant to everyone having an economic interest in an oil and gas property the right to recover, through annual deductions from income, his basis for the property. The basis, when percentage depletion is applicable, is 27½ per cent of the taxpayer's gross income from the property, limited in each year to 50% of his net income therefrom. In the *Herring* case this Court held that a lessor, whose situation was identical with Sneed's, was entitled to a percentage depletion allowance with respect to bonuses received in that tax year, even though there had not then been, and might never be, any production from the property or any actual depletion of the lessor's interest therein. The reason for this was that the allowance could be made only

in the year that gross income (lease bonuses or advance royalties) was received. If the allowance was not made then, the lessor could never recover that much of his basis, no matter how much the property might subsequently produce and be depleted.

In the case at bar Sneed received gross income from the property in 1936, for he then received cash bonuses for the new leases which he made upon the lapsed areas. It was found as a fact that he would receive further gross income from these very areas in subsequent years through development of, and production from, the gas deposits then known to be under these areas. (R. 26, 27.)

Under the *Herring* case it is not necessary that actual depletion occur in the year in which gross income is received and the depletion allowance is made. But it is necessary, if a lessor is to be allowed in the aggregate depletion allowances equal to 27½ per cent of his entire gross income from the property, that no part of an allowance previously made be included in income until and unless it is *certain* that there will never be any production. Therefore, the holding of the Court below, to the effect that the 1926 allowances could be included in 1936 income despite the fact that Sneed received in 1936 additional gross income from the property (the bonuses for new leases) and would receive further gross income through subsequent development under them, clearly conflicts with this Court's holding in the *Herring* case.

IMPORTANT UNDECIDED FEDERAL QUESTION

In *Herring v. Commissioner*, 293 U. S. 322, after deciding that Herring was entitled to a depletion allowance on his cash bonuses, this Court said:

> "As to income tax liability in the year of termination of the lease, on account of bonuses paid on execution of the lease, if no mineral has been extracted, we express no opinion."

Since that decision, this Court has not passed upon any phase of the bonus depletion question. The precise question has not been before any Federal Appellate Court,[13] other than the Fifth Circuit Court of Appeals in this and the subsequently decided Crabb case.[14]

The practice of making oil and gas leases for a cash bonus is practically universal. The question involved here can arise whenever a cash bonus is paid for an oil and gas lease and subsequent operations under that lease fail to produce oil and gas. This happens very frequently. Many cases are pending in the Board and in the Bureau of Internal Revenue involving the identical question.[15]

Clearly the question is important as related to the taxation of income from minerals, and is even more

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[13]The case of Lamont v. Commissioner (C. C. A. 8, 1941), 120 Fed. (2d) 996, dealing with cost depletion allowed on minimum royalties, paid under hard mineral leases, is readily distinguishable. Cf. Brief p. 30, infra.

[14]Dolores Crabb et al. v. Commissioner (C. C. A. 5th, 1941), 119 Fed. (2d) 772; See also Brief p. 30, infra, and appendix, p. 55, infra.

[15]Only the Bureau of Internal Revenue can give accurate information as to the number of such cases.

important when the broader application of the decision is considered,—that is, when consideration is given to the importance of a holding that an amount can be taxed as income in a year in which nothing was received by or accrued to the taxpayer.

Importance of the question is emphasized by Judge Hutcheson's dissenting opinion in *Crabb v. Commissioner*, supra.

CONCLUSION

Wherefore, it is respectfully submitted that this petition for certiorari should be granted.

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NO._____

IN THE

Supreme Court of the United States

OCTOBER TERM, 1941

TERRY THOMPSON, ET AL., INDEPENDENT EXECUTORS OF THE ESTATE OF J. T. SNEED, JR., DECEASED,

Petitioners.

vs.

GUY HELVERING, COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Brief in Support of Petition for Writ of Certiorari to the Circuit Court of Appeals for the Fifth Circuit.

OPINIONS BELOW

The original opinion of the Circuit Court of Appeals is reported at 119 Fed. (2d) 767; the opinion on rehearing at 121 Fed. (2d) 725. The opinion of the Board of Tax Appeals is reported at 40 B. T. A. 1136.

JURISDICTION.

The judgment of the Circuit Court of Appeals was entered May 5, 1941 (R. 95). Petitioners' Motion for

Rehearing, seasonably filed, was denied on July 17, 1941 (R. 106). The jurisdiction of this Court is invoked under Section 240(a) of the Judicial Code, as amended by the Act of February 13, 1925.

STATUTES INVOLVED

Pertinent Statutes and Regulations appear in the Appendix, page 49 infra.

QUESTIONS PRESENTED

Can a portion of certain sums which Petitioners' decedent (Sneed) received in *1926*, and of which he then and thereafter had unqualified ownership and possession, without obligation or liability to anyone, be treated as a part of his taxable income in *1936*, even if:

(a) The total sums received in *1926* were paid to Sneed as bonuses for various oil and gas leases which he made in that year on various portions of a ranch owned by him;

(b) He obtained in *1926* an allowance for percentage depletion with respect to all of these bonuses;

(c) Certain of these leases lapsed in *1936* without development upon the areas covered by the lapsed leases, although the substantial mineral reserves underlying the lapsed lease areas had been partially depleted by production from other wells on the ranch from which Sneed received royalty income; and

(d) The sum included in 1936 income represented the percentage depletion allowed with respect to the bonuses received in *1926* for the leases which so lapsed?

STATEMENT

The statement of facts contained in the petition for certiorari (pp. 3 to 6, supra) sufficiently develops the salient facts. Reference to that statement is respectfully made.

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

(1) In holding that Sneed received income in 1936 in an amount equal to the 1926 allowances for percentage depletion, when oil and gas leases made in 1926 lapsed without production from the leased areas.

(2) In holding that taxing such amount as 1936 income was not contrary to the constitutional and statutory provisions defining income and requiring the calculation of taxable income upon an annual basis.

(3) In holding that Sneed took the 1926 depletion allowances upon condition that they be restored to income when and if it was determined that there would be no production from the particular lease for which the bonus was paid.

(4) In holding, in view of the undisputed fact that the gas reserves in each of the areas covered by the twenty-six leases had been actually depleted, that the amount of the 1926 depletion allowances should be included in Sneed's income in 1936.

(5) In holding, it being conclusively established that there would be production subsequent to 1936 from the twenty-six areas and the 1926 bonuses having

been "income from the property," that the 1926 depletion allowances should be restored to income in 1936.

(6) In refusing to hold that Sneed's entire ranch was one "property," in applying the principle that bonus depletion allowances cannot be restored if the "property" has been depleted during the life of the lease.

SUMMARY OF ARGUMENT

I.

There is no statutory provision or regulation which supports the Respondent's action in including in Sneed's 1936 income the restored depletion here in question. The Regulations relied upon are not applicable and the *ex post facto* rulings of the Respondent's Chief Counsel are of no moment.

II.

In the absence of a statute or regulations supporting the Respondent's action, the controlling test to determine whether this item of restored depletion can be included in Sneed's gross income for 1936 is whether he received, or there accrued to him in 1936, gross income on that account. If not, he cannot be taxed upon it. Admittedly Sneed actually received nothing. No gain accrued to him in 1936. The entire amount of the bonuses was gross income to Sneed in 1926. He was never under any obligation or liability with respect to these bonuses, and therefore could be relieved of none. The depletion allowed him in that year was allowed unconditionally as a matter of legislative grace and

as a deduction from gross income. It is incorrect to say that any gross income went untaxed in 1926.

III.

Even if gross income went untaxed in 1926, it is improper to attempt to correct this alleged error by adding an equivalent amount to gross income for 1936. The general statutes of limitation applicable to tax cases, the limited scope of section 820 of the Revenue Act of 1938 dealing with the mitigation of the effect of Statutes of Limitation in certain income tax cases, and statutory provisions regarding the extent to which percentage depletion previously allowed is to be considered in determining gross income, show that Congress never intended that percentage depletion allowed in 1926 be included in gross income for 1936 under any conditions whatsoever. The same result is supported by controlling decisions of this Court.

IV.

It is established that percentage depletion based upon an oil and gas lease bonus cannot be restored to income when the lease terminates if there has been any production whatsoever from the property. Under applicable Regulations and within the intendment of Congress, Sneed's entire ranch was one property, which was substantially depleted during the ten year life of these leases. These principles are peculiarly applicable to gas properties. So, under the particular circumstances present here, the restoration to income was improper, regardless of the rule which might be generally applied.

V.

This Court's decision in *Herring v. Commissioner*, 293 U. S. 322, requires that the aggregate depletion allowances to be allowed a lessor equal 27½ per cent of the lessor's entire gross income from the property over its life, limited only by the statutory provision that this allowance can in no year exceed 50 per cent of his net income from the property. This case also holds that these percentage depletion allowances can only be made in the year gross income is received and are not to be denied because no actual depeltion occurred in that year. In view of the established facts that, through the making in 1936 of new leases for cash bonuses, Sneed received in 1936 gross income from the lapsed-leased areas, and that he would subsequent to 1936 receive further income through production from these areas, an application of the principles enunciated in the *Herring* case require a holding that the 1926 depletion allowances were erroneously restored to income in 1936.

ARGUMENT

I.

Neither the Respondent nor the Court below asserts that there is, or has ever been, any statutory provision dealing with the restoration to gross income of percentage depletion previously allowed with respect to a bonus. Instead, the Respondent predicated his action upon *Article 216(d) of Regulations 69* (1926 Act), *Article 23(m)-10(c) of Regulations 94* (1936 Act) and *G. C. M. 14,448* (C. B. XIV-1, p. 98), and it appears that the Court below adopted the same view.

G. C. M. 14,448 merits no consideration. It was promulgated in 1935, more than nine years after Sneed had received the bonuses and claimed depletion thereon, and subsequent to this Court's opinion in *Herring v. Commissioner*, 293 U. S. 322, decided December 3, 1934. Although Sneed's 1926 tax case, involving primarily the depletion question, had been decided adversely to him in June of 1934 (30 B. T. A. 1121), prior to this Court's decision in the Herring case and the Board did not reconsider the matter and grant the allowance, as required by the Herring case, until November 15, 1935 (33 B. T. A. 478), it attached no condition to the allowance and did not give consideration to *G. C. M. 14,448*. This Counsel's Memorandum is clearly *ex post facto*. *Cf. Helvering v. Reynolds Tobacco Company*, 306 U. S. 110, and, since it is not an official regulation, is entitled to no particular consideration. *Helvering v. New York Trust Company*, 292 U. S. 455, 468.

If support can be found for the Respondent's action, it must come from the Regulations cited by the Respondent in his deficiency notice.

In dealing with these Regulations, certain basic principles should be borne in mind. One of these has to do with the capital which Sneed had in the mineral reserves under his ranch. We think it clear that from an income tax standpoint capital is cost, or value as of March 1, 1913, if the property was then owned by the taxpayer and is not value at any particular time. If this were not true, then the sale of property at its value would never produce income, but would merely convert capital from one form into another. Under these

principles, Sneed had no capital in the mineral reserves under his ranch for he had acquired them long before the presence of these reserves was suspected, and it is an established principle that in such a case no part of the cost of the land can be allocated to mineral reserves ascertained to exist subsequent to purchase.[1] To illustrate: If Sneed had sold outright the entire mineral content of his ranch in 1925 or 1926, after this mineral reserve was known to exist, he could not have deducted anything from the selling price in order to arrive at his taxable gain because these mineral reserves had no cost — he had no capital in them.

Another factor applicable in considering the Regulations is that an oil and gas lease bonus differs materially from minimum royalties frequently paid under hard mineral leases. A minimum royalty is payment in advance for a specified quantity of mineral to be subsequently extracted.[2] The bonus for an oil and gas lease, although an advance royalty and "gross income from the property" for tax purposes, is not applicable to any specific quantity of oil or gas. No matter how large the bonus, the specified *ordinary* royalties are payable for every barrel or cubic foot of oil or gas extracted. That is true generally, and it is true under the terms of Sneed's particular leases.[3] A bonus pays the advance royalty on whatever quantity of oil or gas the lessee may extract, whether it be one foot of gas or billions of feet.

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[1]Reg. 69, Art. 201, Now Reg. 103, sec. 19.23(m)-2.

[2]This factor distinguishes and renders inapplicable Lamont v. Commissioner, 120 Fed. (2d) 996, discussed infra, p. 30.

[3]R. 75.

Closely connected with the foregoing is the principle accepted by the Respondent and established by a Board of Tax Appeals decision that even if an insignificant amount of oil or gas is extracted by the lessee, no portion of the depletion allowed with respect to the bonus paid for the lease can be restored to the lessor's income when the lease terminates.[4]

From 1918 until the present time there have been extant Treasury Regulations dealing with depletion upon bonuses and advance royalties. There is an important difference between those promulgated prior to the 1926 Act (when percentage depletion was first provided for as a substitute for discovery depletion) and those promulgated under the 1926 and subsequent acts. The earlier pre-1926 Regulations will be first considered.[5] These Regulations provided for an allowance for depletion to a lessor who received a lease bonus or an advance royalty, and then provided that upon the termination of the lease "without the removal of any or all of the mineral contemplated by the lease" the lessor should restore to "capital account" so much of the depletion previously deducted as was "in excess of the actual depletion or loss in value sustained as a result of the operations under the lease, and the corresponding amount will become income in the year in which the lease expires, terminates or is abandoned."

Assuming the validity of these Regulations, despite the fact that they were held invalid by the Board of Tax

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[4]Dolores Crabb et al., 41 B. T. A. 686, in which respondent acquiesced, 1940-2 C. B-2; G. C. M. 14,448 discussed supra, p. 23.

[5]Art. 215(d), Reg. 62 (R. A. 1921); Art. 216(d), Reg. 65 (R. A. 1924), Appendix B, p. 51, infra.

Appeals in two cases — *Knapp*, 7 B. T. A. 790, and *Cooper*, 7 B. T .A. 798, decided in 1927, and that the Respondent acquiesced in these decisions and kept his acquiscence in effect until the latter part of 1933,[6] it is clear that so much of the Regulations as dealt with the restoration of bonus depletion previously allowed *referred only to depletion allowed against the capital which the lessor had in the reserves.* The Regulations throughout speak of "capital" and "capital account" an to "adjustment of capital account." These phrases are applicable to depletion based on cost or value as of March 1, 1913, but they have no application whatsoever to depletion based upon discovery value (the third basis for depletion prior to the time percentage depletion was substituted therefor by the 1926 Act), because as heretofore pointed out value at any particular date is not capital either in common understanding or for tax purposes. Another reason why the Regulations, as they existed prior to the 1926 Act, had no application to discovery depletion is because discovery depletion was only applicable when there had been a discovery of oil with production. As above pointed out, when there has been production of oil or gas, even though small in amount, it is established that no part of the depletion allowed with respect to a bonus can be restored to income when the lease terminates.[7]

Thus, until the Revenue Act of 1926, the Regulations only required the restoration of depletion allowed with respect to a bonus or an advance royalty when the les-

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[6]Acquiescence withdrawn: Knapp, VII-1 C. B. 17; Cooper, VII-1 C. B. 7.

[7]Note 4, supra.

sor had capital invested in the lease, and limited that restoration to the amount by which depletion previously allowed exceeded "actual depletion or loss in value sustained as a result of operations under the lease."[8]

The percentage depletion provisions contained in the Revenue Act of 1926 and later Acts were a substitute for discovery depletion.[9] Regulations 69, promulgated under the 1926 Act, continued, in sub-paragraphs (a) to (d), both inclusive, of Article 216, the substance of the earlier Regulations with respect to depletion on bonuses or advance royalties which has just been discussed, and added thereto to cover the percentage depletion provisions of the 1926 law the following sub-paragraph (e):

> "In lieu of the treatment provided for in the above paragraphs, the lessor of oil and gas wells may take as a depletion deduction in respect of any bonus, royalties, and other income from the property in the taxable year 27½ per cent of the amount thereof, but the deduction shall not exceed 50 per cent of the net income (computed without allowance for depletion) from the property."

It is the present position of the Respondent, and the position taken in G. C. M. 14,448, that the earlier subdivisions of the Article which contain the above quoted provision, insofar as they deal with the restoration of depletion previously allowed, are applicable to percent-

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[8]Arts. 215(d) and 216(d) of Regs. 62 and 65, supra, Note 5, Appendix, p. 51.

[9]Cf. Report, Ways & Means Committee (69th Cong. 1st Sess. H. Rept. 1); Report, Senate Finance Committee (69th Cong., 1st Sess. S. Rep. 52).

age depletion. But it is obvious that this position is only an afterthought, for in the *Herring* case heretofore dealt with, and in *Sneed's* own 1926 case, the Bureau of Internal Revenue strenuously contended that no depletion could be allowed with respect to a bonus, unless there had been actual production from the property, and it was then, and is now the rule that if there had been actual production from the property under the lease no part of the bonus depletion could be restored to income.[10] So the essence of Respondent's present position, and the position taken in G. C. M. 14,448, is that in promulgating the 1926 Regulations, and in all Regulations prior to this Court's decision in the Herring case, the Treasury Department was carefully providing for the restoration of an allowance that they believed and strenuously contended was never allowable in the first instance.

Not only this, but subdivision (e) of Article 216 of Regulations 69 above quoted contains nothing whatsoever as to the restoration of percentage depletion, but it does say that the provisions of that Article are "in lieu of the treatment provided for in the above paragraphs," which above paragraphs are the only ones which deal with the restoration of depletion under any circumstances whatsoever.

The only answer which Respondent has ever been able to make about this is contained in G. C. M. 14,448, which says, in substance, that the allowance for bonus depletion, which Herring, Sneed and others similarly situated finally obtained after prolonged contests with

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[10]Authorities cited Note 4, Supra, p. 25.

him, was obtained upon condition that it be restored. The Court below, however, was able to torture this meaning out of the quoted phrase beginning "in lieu":

> "This amounts to saying that (e) is in lieu of (a), (b), (c) and (d) *perhaps so far* as it speaks of a capital account, but not so far as restoration to income is concerned."[11]

This, we submit, is an entirely insupportable construction of the plain phrase "in lieu of the treatment, etc." The error is so clearly pointed out in Judge Hutcheson's dissenting opinion in the *Crabb* case[12] that we will not discuss it further.

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[11]The lower court said: "It is argued that while the cost or discovery value basis deduction is and has always been subject to (d) above quoted, the meaning of (e) is that the percentage deduction is absolute and final. The Commissioner's General Counsel did not think so when he ruled upon the matter in 1935, after the decision in the Herring case (XIV-1 Cum. Bul. p. 98); but he held that the meaning of the Herring case, in connection with Murphy Oil Co. v. Burnet, 287 U. S. 299, which dealt with a cost-basis depletion allowance, and referred with approval to the Regulations under discussion, was that the deduction was the same in nature and purpose however measured, and the Regulations meant to treat them alike when the lease ended without production." The Murphy Oil Company case involved the Revenue Act of 1918, and the Regulations promulgated thereunder, and had nothing whatsoever to do with percentage depletion nor restoration of depletion; the reference in the Murphy case was not an approval of any regulation, but merely an explanation; in that case the question was primarily whether bonus payments were subject to depletion. Moreover, the Murphy case was decided long before the Herring case, in which decision of the question here involved was expressly left open.

[12]Crabb v. Commissioner (C. C. A. 5, 1941), 119 Fed. (2d) 772, Appendix, p. 55, infra.

There is a sound basis in fact and in law for the conclusion that Paragraph (d) of *Article 216, Regulations 69,* providing for restoration of depletion, was not intended to have application, and in fact does not have application, to instances of percentage depletion. And, parenthetically, the matter to be discussed distinguishes the present situation from that in *Lamont v. Commissioner of Internal Revenue* (C. C. A. 8th, 1941), 120 Fed. (2d) 996, where the taxpayer deducted depletion based on March 1, 1913 value on a total of 581,301 tons of iron ore on which minimum royalties had been received during prior years of the lease; the Commissioner determined that the depletion so deducted on unmined ore should be restored to income in the year the iron lease was cancelled. Cost or March 1, 1913 value are elements taken into consideration in determining gain or loss when property is sold, abandoned or destroyed. Any cost or March 1, 1913 value not previously recovered by depletion can always be recovered in case of subsequent production. Thus when bonus depletion allowed upon cost or March 1, 1913 value is restored to capital account, the lessor is not denied depletion upon or recovery of that much of the restoration. If he makes a new lease he can use the restored capital as the basis for depletion upon bonuses or royalties received under the new lease; if he disposes of the property the restored capital is recovered by being deducted from the selling price; if the property is abandoned the restored capital is charged off as a loss. But not one of these factors is present in the case of percentage depletion. No matter how much the property may produce subsequent to the termination

of the first lease, if the Respondent is correct in his present position, then his theory irretrievably deprives the lessor of a portion of the statutory depletion allowance, for percentage depletion cannot be restored to capital account. Once an effort to restore is successful, the allowance is gone forever. Returning depletion based upon cost or March 1, 1913 value to capital account is *restoration;* the same thing with regard to percentage depletion is *deprivation.* Thus the reason that subdivision (e) of Article 216 of Regulations 69 is really *in lieu* of the preceding subdivisions of the article, including (d) — which provides for restoration of depletion — becomes crystal clear.

It is submitted, therefore, that there is not, and has never been, any statutory provision or Treasury Regulation purporting to require a lessor, who is allowed percentage depletion upon an oil and gas lease bonus, to restore any part of that depletion to income under any circumstances whatsoever.

II.

Since the decision below cannot be supported by express statutory provision or Treasury Regulation, it must be supported, if at all, by the general provisions of the Revenue Act of 1936 defining the income taxed to individuals by that Act. That Act levies a tax "for *each taxable year* upon the net income of every individual."[13] It defines net income as gross income less authorized deductions, and provides, in *section 42*, that "the amount of all items of gross income shall be included in the gross income for the taxable year in

[13]Sec. 11, R. A. 1936.

which received by the taxpayer, unless, under methods of accounting permitted under *section 41* any such amounts are to be properly accounted for as of a different period." The methods of accounting required by *section 41* are: "The net income shall be computed upon the basis of the taxpayer's *annual accounting period* * * * in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income."

This Court has heretofore dealt with the same, or corresponding provisions, in revenue legislation on many occasions, and has applied them in a way diametrically opposed to the holding of the Court below. The rules announced by this Court may be thus summarized:—receipt of income or accrual of the right to receive it within the tax year is the test of taxability; and all calculations of net and gross income must be made upon the basis of the statutory tax year. *Guaranty Trust Company v. Commissioner*, 303 U. S. 493, 498; *Burnet v. Sanford & Brooks Company*, 282 U. S. 359, 363; and *Burnet v. Thompson Oil & Gas Company*, 203 U. S. 301, 306, are sufficient support for this statement.

Therefore, we confidently assert that Sneed cannot be taxed upon the restored depletion in 1936, unless he received income within that year, or the right to receive it accrued to him. The fact that the leases terminated in 1936 merits no consideration. It was not

the basis of the Respondent's determination.[14] If that was the measure of Sneed's income, it would be limited to the value of those lapsed leases in 1936, which value he immediately realized by making new leases for bonuses which he reported as gross income and, as the Court below said "in truth he got nothing back; the lease simply perished according to its original terms."[15]

Of course the cash bonuses were gross income to Sneed in 1926 in accordance with this Court's decision in the *Harmel*[16] and *Herring* cases, but these bonuses — cash — were received by Sneed as his own property unconditionally, without limitation or liability to anyone in 1926, and, for aught this record shows, they might have been spent many years prior to 1936. The fact that they were gross income to Sneed in 1926, instead of supporting the Respondent's position, demonstrates conclusively that they could not be gross income in 1936.

Nor can it be said, even if it were controlling (but as to this see page 37, infra), that any portion of these bonuses were unreported in 1926 or untaxed in that year. Sneed reported all of the bonuses as a part of his gross income. He took deductions from that gross income in accordance with the statute as construed by this Court in the Herring case, but that no more supports the assertion that the bonuses were not taxed in 1926 than would the fact that Sneed reduced his tax liability by claiming a personal exemption as the head

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[14]Deficiency notice, R. 14.

[15]R. 89.

[16]Burnet v. Harmel, 287 U. S. 103, 53 S. Ct. 74.

of a family, or that he might have deducted any losses, which he had sustained, from his gross income from bonuses. Depletion allowances are not exclusions from gross income, but statutory deductions allowed as a matter of congressional grace.[17]

The most plausible support for the Respondent's position is derived from those cases which hold that the recovery of a bad debt previously charged off, the retirement of an obligation at less than its issuing price, the forgiveness of an indebtedness, the recoupment of a previously deducted expense or tax, or the avoidance of a previously accrued expense or tax, or the freeing of reserves from their offsetting liability produce taxable income when the event happens. But there is no real analogy between those situations and the one under consideration. This Court's decision in *United States v. Kirby Lumber Company*, 284 U. S. 1, and *Maryland Casualty Company v. United States*, 251 U. S. 342, are the leading cases of the type upon which the Respondent must rely here. But the controlling factors in these cases, and in all other similar cases, are that there was either an actual receipt of something within the tax year which had no basis in the recipient's hands because of previous deductions from income, or there was an actual enhancement in wealth realized through the freeing of the taxpayer from enforceable liabilities.

In the *Kirby Lumber Company* case in which the corporation had repurchased its bonds at a discount, this Court said:

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[17]Anderson v. Helvering, 310 U. S. 404, 60 S. Ct. 952; Helvering v. Bankline Oil Co., 303 U. S. 362, 58 S. Ct. 616.

"As a result of its dealings it made available $137,521.30 assets *previously offset by the obligation of bonds now extinct.* We see nothing to be gained by the discussion of judicial definitions. The defendant in error has realized within the year an accession to income, if we take words in their plain popular meaning, as they should be taken here."

In the *Maryland Casualty Company* case, which dealt with insurance reserves, the Court emphasized that the excess in the reserves upon which the tax was based "*was released to the general uses of the company and increased its free assets in 1913*" the year in which it was sought to be taxed. There is nothing similar in the instant case. None of Sneed's obligations were extinguished in 1936. No asset which Sneed had was made more available to him in 1936 than it was in previous years. There was nothing which met either the statutory conception of realization of income within the taxable year, or the popular meaning of these words.

An examination of all of the cases[18] cited by the Court below upon this point will clearly reveal that none is applicable here because of the factors just discussed.

The error in the statement of the Court below that "but where the return is correct on the facts, as they were when it was made, but occurrences in a later year alter the case, the adjustment is generally to be made in the later year" is conclusively shown by the practice consistently followed in closely analogous sit-

[18]See cases cited R. 93.

uations which have arisen innumerable times. The allowance for depletion is closely akin to the reasonable allowance for depreciation, etc., allowed by statute. The customary method of allowing depreciation is to estimate the useful life of a depreciable asset and its salvage value at the termination of its useful life, to deduct the estimated salvage value from the cost and to grant allowances each year over the estimated life so that the difference between cost and salvage value can be thus recovered. It has happened in innumerable cases that subsequent events have conclusively demonstrated that a depreciation allowance for a prior year was too large. For example, it might be estimated when a machine was acquired that its useful life would be five years, yet at the end of the five year period the machine might be still in active use. If the holding of the Court below is sound, the correct practice would be to add to the income of the year, in which it was discovered that an erroneous estimate had been made, the excessive depreciation previously allowed. Yet, although such errors have been discovered in thousands and thousands of cases, it has never been suggested that such a course could be followed. The consistent practice of the Bureau has been, if the recoverable cost has been already recouped, to deny further deductions in subsequent years, and, if there remains any recoverable cost, to decrease the rate so that over the life of the asset, as newly estimated, the remainder will be recouped.

The situation here fails to meet this Court's requirement that receipt of income or accrual of the right to receive it within the tax year is the test of taxability.

III.

But if we assume, as the Court below erroneously assumed, that gross income went untaxed in 1926, the lower Court's holding that since limitation prevented correcting the error in 1926, the adjustment is generally to be made in the later year, is clearly erroneous. Much that has been said above as to the requirement that income be received or accrue within the tax year in order to be taxable is applicable here.

In addition, it is clear that there is no element of estoppel to support the Respondent's position. There was no misrepresentation, concealment or anything which would support estoppel. Sneed reported his entire gross income in 1926. He claimed his deduction; it was denied him; he fought for it and obtained it. That is the whole story. He cannot be estopped when he attempts to retain the benefit which he thus obtained.

There is much in revenue legislation to indicate that Congress never intended the result reached by the Court below. There have always been statutes of limitation, except in the case of fraud, upon the Government's right to collect additional taxes. What possible value would those statutes be if they were applied as the Court below applied them? That is to say, in substance, that it having been ascertained in one year that an insufficient amount of income had been taxed in a previous year, but statutes of limitation prevented reopening the year in which the income was received, it is appropriate to include a corresponding amount in a later year when nothing was received by

or accrued to the taxpayer. Any such theory entirely avoids the ordinary statutes of limitation.

Congressional intention that no such result would follow is further shown by section 820 of the Revenue Act of 1938, carried forward and now *Section 3801 of the Internal Revenue Code.* The purport of this section is to mitigate the effect of limitation statutes where it has been determined that income has been reported or a deduction taken in the wrong year or vice versa. But Congress carefully limited the application of this section to errors made in the year *1932 and subsequent years;* thus clearly evidencing an intention that earlier years were to remain at rest. In the case at bar if any income was untaxed, it was income for 1926 and section 820 of the Revenue Act of 1928 forcefully shows that Congress wanted no reconsideration of tax liability for that year, or any year prior to 1932.

A change in revenue legislation first made in 1932, and carried forward in all subsequent Acts, supports the same conclusion. Prior to the passage of the Revenue Act of 1932, the rule always applied in determining the gain from the sale of a depletable interest in an oil property was that the basis for determining gain or loss from the sale was to be reduced by so much of the depletion previously allowed as was based on cost or value as of March 1, 1913, but not depletion allowed upon discovery value or upon the percentage of income basis to the extent that such allowances exceeded the depletion allowed based upon cost or March 1, 1913 value.

By section 113(b) of the Revenue Act of 1932, this

was changed to provide that the basis should be reduced by discovery or percentage depletion allowed for the year 1932, and subsequent years. This clearly indicates a congressional intention that percentage depletion allowed prior to 1932 — and the allowances here involved were made in 1926 — should not be taken into consideration in determining income for subsequent years.

The rule generally applied by the lower courts in situations comparable to that here under discussion conforms to the principle announced by this Court in *Guaranty Trust Company v. Commissioner*, 303 U. S. 493, heretofore dealt with, that receipt or accrual of income within the taxable year is the test of taxability. Some attempts have been made to vary the application of this rule by applying the doctrine of estoppel. But it is clear here that Sneed was not estopped to deny that he received income in 1936 when the 1926 leases lapsed. The case of *Helvering v. Schine Chain Theaters Inc.*, 121 Fed. (2d) 948, decided July 21, 1941, by the Second Circuit Court of Appeals, is directly in point here. It is discussed at some length in the preceding petition for certiorari. Other cases by Courts and the Board of Tax Appeals, applying the same principle, are cited in the footnotes.[19]

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[19]Commissioner v. Speyer (C. C. A. 2), 77 Fed. (2d) 824; Creasey Corp. v. Helburn (U. S. D. C., Ky.), 57 Fed. (2d) 204; Grauman's Greater Hollywood Theatre Inc., 37 B. T. A. 448; Sugar Creek Mining Company, 31 B. T. A. 344; and see, generally, the cases cited 1 Paul & Mertens, Federal Income Taxation, p. 481, Para. 11.03.

IV.

We have heretofore referred to the fact that the bonus paid for an oil and gas lease does not, as minimum royalties do, pay in advance for any specific quantity of oil or gas to be subsequently produced. Because of this, if a lessee produces any oil or gas whatsoever under the lease the property has been actually depleted and, under the Respondent's own rulings, no part of the depletion allowed with respect to a bonus can be restored when the lease terminates, and this, regardless of how small the amount of the oil or gas produced might be. The Board of Tax Appeals applied this principle in *Crabb v. Commissioner*, 41 B. T. A. 680, and, although the petition appealed upon other questions, the respondent did not.

This principle, petitioners submit, is of controlling importance here, regardless of how the Court might decide a case in which a lessor leased his entire holdings of land to one lessee and that lease terminated without any production whatsoever.

Petitioners' argument here is this:—Sneed's ranch was one property from his standpoint. It was underlain with one continuous, migratory stratum of gas, all of which, under the evidence and findings, could ultimately have been produced through any one or more wells located anywhere on the ranch, in just the same way that any one outlet to a body of water will ultimately drain off all of the water in the body that can by gravity flow into the outlet. During the term of the leases which lapsed in 1936 very large quantities of gas were produced from this ranch, and a substantial

quantity of this production came from under the areas upon which the leases lapsed.[20] Thus, during the term of these leases there was actual depletion, and consequently under the principle above announced and under the *Crabb* decision no part of the bonus depletion allowed in 1926 can be restored to income in 1936, when the leases lapsed.

The controverted point in the application of this theory is whether Sneed's ranch, for depletion purposes, was one property or whether there were from his standpoint as many different properties as there were separate leases. The statute has never defined "the property." It merely provides that in the case of oil and gas wells the allowance for depletion shall be 27½ per cent of the gross income from "the property" and that in the case of leases all allowances for depletion shall be equitably apportioned between the lessor and lessee. The definition of "the property" has varied to some extent in various regulations. Under the earlier discovery depletion provisions the property to be revalued extended "to the limit of the taxpayer's private bounding lines, but not beyond the limits of the proven area as heretofore provided."[21] Under this definition and the established fact that the gas stratum extended under the entire ranch, it would appear that the entire ranch was one property. In other Regulations it is stated "In general 'the property,' as the term is used in section 204(c)(2) of this Article re-

[20]R. 26-27, 56-58.

[21]Art. 220(a)(3) Reg. 45, (R. A. 1918); Arts. 201(c), 214 and 220(a)(3) of Reg. 62 (R. A. 1921) and Reg. 65 (R. A. 1924).

fers to the separate tracts or leases of the taxpayer."[22] Sneed had no leases. The tract of land which he owned was the entire ranch. In other Regulations[23] "the property" is defined as "the mineral deposit, the development and plant necessary for its extraction and so much of the surface of the land *as is reasonably expected to be underlaid with the mineral.*" Under this definition it is clear that Sneed's entire ranch would, from his standpoint, be "the property."

Beginning with Regulations 45 (1918 Act) and continuing through Regulations 69 (1926 Act), the later Regulations being the one under which Sneed's allowances were made for 1926, it was provided that the recoverable oil belonging to the taxpayer should be estimated for each property separately, but that "in the case of gas properties the depletion allowance for each pool shall be computed by using the combined capital account returnable through depletion of all the tracts of gas land owned by the taxpayer in the pool and the average decline of rock pressure of all the taxpayer's wells in such pool, etc."[24] Since it is definitely established that the gas pool from which the production came extended under all of Sneed's ranch and beyond, this Regulation would support Sneed's position here even though each lease which he made might be considered a separate property.

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[22]Art. 221 of Reg. 69 (R. A. 1926).

[23]Art. 221 of Reg. 74 (R. A. 1928).

[24]Art. 214(a) of Reg. 45 (R. A. 1918); Art. 214 of Reg. 62 (R. A. 1921); Art. 215 of Reg. 65 (R. A. 1925); Art. 215 of Reg. 69 (R. A. 1926), Appendix, p. 51, infra.

It is reasonable and fair to treat Sneed's ranch as one property. His royalties were the same regardless of what portion of the ranch the producing wells were located upon. Any well on his ranch drained from the entire pool. The fortuitous circumstance that he made several leases should not decrease the aggregate of his depeltion allowances beyond what they would be had he made only one lease for an aggregate bonus equal to all of the bonuses received and this lease had been followed by the development and production which has actually occurred upon his entire ranch. The Court below met this by stating:

> "The actual depletion of gas under these lands through wells drilled under other leases is compensated by the depletion allowances made at those wells. There would be a double allowance if it were also allowed here."

This entirely overlooks the fundamental theory with respect to percentage depletion allowances. Percentage depletion is not measured by the quantity of oil or gas produced, but is measured by the taxpayer's gross income from the property. So when some of the gas which was actually under the areas as to which the leases lapsed was extracted through wells located elsewhere on the ranch and Sneed received his ordinary royalties thereon, these royalties were only a part of his gross income from the property. He was of course entitled to depletion with respect to the portion of his gross income represented by ordinary royalties, but he was none the less entitled to depletion with respect to every other item of gross income from his property. What Sneed claims here is no more a double deduction

than it is a double deduction to allow a lessor depletion with respect to an advance royalty or bonus, and then allow him depletion on his ordinary royalties when he receives them under that lease. His aggregate allowances will never exceed 27½ per cent of his gross income from the property, and anything less will deprive him of a portion of the statutory allowance which Congress clearly intended to grant him, and which this Court has upheld in the *Herring* and many other cases.

So, we submit that Sneed's ranch was one property; it was actually depleted during the life of the leases which lapsed in 1936, and , therefore under the principles here discussed, no portion of the depletion allowed in 1926 can be restored to income, and this is true regardless of how the question might be decided had there been no production whatsoever during the life of these leases from other portions of the ranch.

V.

Under this Court's decision in the *Herring case*, percentage depletion with respect to a lease bonus is to be allowed in the year the bonus is received, regardless of when there is actual production from the property. The reasoning is this: the basis for the allowance is gross income from the property. Advance royalties are a part of that gross income. The allowance is to be made annually upon this basis, and if it is not made as to each item of gross income from the property when it is received, the deficiency cannot be made up in a subsequent year, no matter how great the production and subsequent depletion.

When this principle is considered in the light of the fact that nowhere in the statute or Regulations is there any limitation upon the method by which a lessor might realize gross income from the property, or any requirement that each leasing transaction should be considered separate from the others, it is clear that the holding of the Court below will, under the very unusual facts in this case, certainly deprive Sneed of a portion of the allowances to which the statute entitles him.

The unusual facts are these: It was known with absolute certainty during the life of the lapsed leases, and when they lapsed, that there were commercially productive quantities of gas under each area. New leases were made on each area and it was certain that subsequent to 1936 there would be development upon these particular areas and subsequent production therefrom.

So, since there is no authority in statute or regulations for the proposition that the lessor's percentage depletion allowances are limited by the gross income which he receives under a particular lease, rather than by his "gross income from the property," Respondent's action and the decision of the Court below permanently deprived Sneed of a portion of the allowances granted him by statute. Here again, this result is a clear demonstration that the decision below was erroneous, regardless of how the basic question might be decided when only the ordinary circumstances were present.

The discussion of this point by the Court below is not convincing. The Court said, in part:

"The bonuses in question are, it is argued, 'in-

> come from the property' under the statute whether in 1926 or 1936. But in 1936 they did not, as was assumed in 1926, represent any depletion."

The correct statement is that, while there had not been any production from these areas in 1936, it was even more certain then than it was in 1926, that there would ultimately be production from, and actual depletion of, them. The Court also emphasized here the statutory phrase "in the case of oil and gas wells." But the presence of an oil and gas well is no more necessary to retain the depletion allowance previously granted than it was to authorize it in the first place, and that question was finally settled by this Court in the *Herring case*. It may be, as the Court below suggested, "unreasonable to permit an allowance for depletion when no well is ever opened." But it is even more unreasonable to deny permanently an allowance for depletion with respect to an advance royalty when it is certain that wells will be opened and will produce in the future, and when the statute bases the allowance on the entire gross income from the property and not under one particular lease, and when the Regulations construe these provisions to allow "annual depletion and depreciation deductions which, in the aggregate, will return to him the cost or other basis of such property * * *." Reg. 94, Art. 23(m)-1.

CONCLUSION

It is respectfully submitted that the decision below is erroneous; deals with an important question of federal law; conflicts with controlling decisions of this

Court and with decisions of other Circuit Courts of Appeals, and that the Petition for Certiorari should be granted and the decision below reversed.

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APPENDIX A

Statutes

The allowances for depletion made to Sneed in 1926, were made under the following provisions of the Revenue Act of 1926:

"Deductions allowed Individuals

"Sec. 214(a) In computing net income there shall be allowed as deductions: * * *

"(9) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In the case of leases the deduction allowed by this paragraph shall be equitably apportioned between the lessor and lessee; * * *

"Sec. 204(c)(2). In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph."

The Revenue Act of 1936, under which the tax here involved was proposed, levied a tax upon the net income of individuals (section 11) which was determined (see section 21) by deducting from gross income (as

defined in section 22) the deductions allowed by section 23.

Gross income was defined in section 22 to include:

> "* * * gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever."

An allowance for depletion was provided in section 23(m) and section 114(b)(3) in language, insofar as pertinent here, identical with that contained in the Revenue Act of 1926.

In providing for the basis to be used for determining the gain or loss from the sale or other disposition of property, it was provided in section 113 that the unadjusted basis for such property should be adjusted for depletion allowances previously made as follows:

> "Section 113(b)(1) General Rule.—Proper adjustment in respect of the property shall in all cases be made— * * *
>
> (B) in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent allowed (but not less than the amount allowable) under this Act or prior income tax laws. Where for any taxable year prior to the taxable year 1932 the depletion allowance was based on discovery value or a percentage of income, then the adjustment for depletion for such year shall be based on

the depletion which would have been allowable for such year if computed without reference to discovery value or a percentage of income; * * *."

The Revenue Act of 1936 contained no provision, other than section 113(b)(1)(B) just above quoted, directing that percentage depletion allowed in a prior year should be taken into consideration to any extent whatsoever in determining taxable income.

Correlation of Regulations Dealing With Bonus Depletion

Regulations 45 (1918 Act) Article 215

Depletion—Adjustments of accounts based on bonus or advanced royalty.—(a) Where a lessor receives a bonus or other sum in addition to royalties, such bonus or other sum shall be regarded as a return of capital to the lessor, but only to the extent of the capital remaining to be recovered through depletion by the lessor at the date of lease. If the bonus exceeds the capital remaining to be recovered, the excess and all the royalties thereafter received will be income and not depletable. If the bonus is less than the capital remaining to be recovered by the lessor through depletion, the difference may be recovered through depletion deductions based on the royalties thereafter received. The bonus or other sum paid by the lessee for a lease made on or after March 1, 1913, will be his value for depletion as of date of acquisition.

(b) Where the owner has leased a mineral property for a term of years with a requirement in the lease that the lessee shall extract and pay for, annually, a specified number of tons, or other agreed units of measurement, of such mineral, or shall pay, annually, a specified sum of money which shall be applied in payment of the purchase price or royalty per unit of such mineral whenever the same shall thereafter be extracted and removed from the leased premises, the value in the ground to the lessor, for purposes of depletion, of the number of units so paid for in advance of extraction will constitute an allowable deduction from the gross income of the year in which such payment or payments shall be made; but no deduction for depletion by the lessor shall be claimed or allowed in any subsequent year on account of the extraction or removal in such year of any mineral so paid for in advance and for which deduction has once been made.

Regulations 69 (1926 Act) Article 216

Depletion—Adjustments of accounts based on bonus or advanced royalty.—(a) Where a lessor receives a bonus in addition to royalties, there shall be allowed as a depletion deduction in respect of the bonus an amount equal to that proportion of the cost or value of the property on the basic date which the amount of the bonus bears to the sum of the bonus and the royalties expected to be received. Such allowance shall be deducted from the amount remaining to be recovered by the lessor through depletion, and the remainder is recoverable through depletion deductions on the basis of royalties thereafter received.

(b) Where the owner has leased a mineral property for a term of years with a requirement in the lease that the lessee shall extract and pay for, annually, a specified number of tons, or other agreed units of measurement, of such mineral, or shall pay, annually, a specified sum of money which shall be applied in payment of the purchase price or royalty per unit of such mineral whenever the same shall thereafter be extracted and removed from the leased premises, the value in the ground to the lessor, for purposes of depletion, of the number of units so paid for in advance of extraction will constitute an allowable deduction from the gross income of the year in which such payment or payments shall be made; but no deduction for depletion by the lessor shall be claimed or allowed in any subsequent year on account of the extraction or removal in such year of any mineral so paid for in advance and for which deduction has once been made.

(c) If, for any reason, any such mineral lease shall be terminated or abandoned before the mineral which has been paid for in advance has been extracted and removed, and the lessor repossesses the leased property, the lessor shall adjust his capital accounts by restoring to the capital sum of the property the depletion deductions made in prior years on account of royalties on mineral paid for but not removed, and his income account shall be adjusted so as to include the amount so restored to capital sum as income of the year such lease is terminated or the property repossessed, and the tax thereon paid.

(d) Upon the expiration, termination, or abandonment of a lease, without the removal of any or all of the mineral contemplated by the lease, the lessor shall be required to restore to capital account so much of the bonus received and deducted from capital recoverable through depletion as is in excess of the actual depletion or loss in value sustained as a result of the operations under the lease and the corresponding amount will be income for the year in which the lease expires, terminates, or is abandoned.*

*Regulations 62 (1921 Act) Article 215 and regulations 65 (1924 Act) Article 216 followed closely the above quoted article of Regulations 45 (1918 Act). Minor differences in verbiage exist, but these are unimportant, and do not affect the scope or sense of the Article.

(c) If for any reason any such mineral lease shall be terminated or abandoned before the mineral which has been paid for in advance has been extracted and removed, and the lessor repossesses the leased property, the lessor shall adjust his capital accounts by restoring to the capital sum of the property the depletion deductions made in prior years on account of royalties on mineral paid for but not removed, and his income account shall be adjusted so as to include the amount so restored to capital sum as income of the year such lease is terminated or the property repossessed, and the tax thereon paid.

(d) Upon the expiration, termination, or abandonment of the lease, without the removal of any or all of the mineral contemplated by the lease, the lessor shall be required to restore to capital account the excess of the depletion theretofore allowable in respect of the bonus and royalty payments over the actual depletion or loss in value sustained as a result of the operations under the lease, and a corresponding amount must be returned as income for the year in which the lease expires, terminates, or is abandoned.

(e) In lieu of the treatment provided for in the above paragraphs the lessor of oil and gas wells may take as a depletion deduction in respect of any bonus, royalties, and other income from the property for the taxable year 27½ per cent of the amount thereof, but the deduction shall not exceed 50 per cent of the net income (computed without allowance for depletion) from the property.*

*Article 236 Regulations 74 (1928 Act); Article 230 Regulations 77 (1932 Act); Article 23(m)-20 of Regulations 86 and 94 (1934 and 1936 Acts) follow closely the above quoted Article 216 of Regulations 69 (1926 Act). There are minor differences in verbiage, but these are unimportant and do not affect the scope or sense of the later regulations.

APPENDIX C

Crabb v. Commissioner, 119 Fed. (2d) 772 (C. C. A. 5th) — dissenting opinion of Circuit Judge Hutcheson:

"I think it plain that the opinion in the *Sneed* case which the majority opinion adopts here, erroneously held applicable to the statutory 27½% depletion, or if applicable, erroneously held valid, the regulation of the Commissioner for restoring depletion taken on the cost basis, because as so applied, it is both invalid and unjust. I therefore dissent from the holding that the statutory 27½% depletion taken in 1934 on an oil lease cash bonus, received in that year, must be returned as income in 1936, when the lease lapsed without any oil or gas having been produced therefrom.

"The statute in making its provision for an arbitrary depletion allowance of 27½% makes no provision for restoring any part of it. The provision in 23 M,[1] on which the majority relies, that the reasonable allowance there provided, shall be made under rules and regulations to be prescribed by the Commissioner, does not support, it defeats the majority view. For, by its clear and definite provisions for a reasonable allowance as contrasted with the fixed arbitrary of 27½% allowed under Section 114-(3), the statute shows beyond question that while the depletion on cost basis, was

[1]Sec. 23(m) Depletion.—"In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. * * *."

to be a reasonable sum to be allowed under Commissioner's rules, the Statutory 27½% depletion was to be allowed whether reasonable or not, and was fixed not under rules to be established by the Commissioner, but at the arbitrary figure of 27½%.

"I think it clear therefore, that when the taxpayers in the exercise of their option, elected to take their depletion on their cash bonus, on the arbitrary, rather than the cost basis, they did so, with the knowledge that they might never get their cost back and might therefore, be paying taxes not on gains but on capital. Having elected that course with its chances of gain, if their capital cost was low, and of loss if their capital cost was high, they may not be interrupted in midflight, and dashed to the ground by the application to them of a regulation designed for and applicable only to cost basis depletion.

"The opinion in the *Sneed* case, with I think, total irrelevance, and with deference, without a full consideration of the fact, that the law and regulations apply as well to taxpayers whose costs in the acquisition of oil lands and leases are high, as to those whose costs are low, states; 'the percentage depletion allowance is more favorable to the taxpayer as its choice in this and other cases, shows. It should not be made still more favorable by making it final in the case of a bonus deduction.' This consideration, whether the law is more or less favorable to the taxpayer than it ought to be, is of course, under our constitutional system, matter for Congress, and not for the courts, and cannot of itself, add words to or take them from a statute or permit the Commissioner or the courts to do so. Without doubt, Congress took into con-

sideration, the oil business as a whole and determined that the law as enacted, would in the long run, while furnishing a simple and workable system, apply justly to both taxpayer and government. Being a general law and not one for an individual case, it applies as well to those who own their oil rights at small cost and to those who have paid large sums for them. It was designed to furnish to those who preferred to take the long run chance that they would get their capital investment back that way, a simple and easy method of doing so, in lieu of the more complicated but more certain method of getting it back, provided under the Commissioner's rules for taking it on the cost basis.

"To apply the cost basis rules, promulgated by the Commissioner, to the taxpayers here who have elected not the cost, but the arbitrary basis, is for the government to keep the promise to the ear while it breaks it to the hope. It is to nullify the statutory grant of an arbitrary depletion, by the application to it of a regulation, not promulgated or intended to apply to such cases, and if intended, without effect as to them, because not authorized by the statute.

"It is true enough that by a rough and ready measurement the arbitrary allowance is supposed to produce and perhaps speaking roughly, does produce, as to taxpayers as a whole, substantially the same result as the cost basis. But it is equally true as said by the board in this case, in holding that because there was some, though very small production from one tract, there could be no restoration of the depletion allowance, 'Percentage depletion is not based on cost and has no relationship to cost. Under the respondent's own ruling,

(the 1935 G. C. M., 14,448, C. B. XIV-1, Page 98), the depletion allowed in 1934 should not be restored to income because there has been actual production.' (41 B. T. A. 686-700.)

"It will be here noted that the ruling referred to and on which the board and the court rely, was made in 1935, after the depletion in this case had been taken and it is made *ex post facto* in an effort to conform the regulation to a situation it had not been written to apply to, the holding in *Herring v. Commissioner*, 293 U. S. 322, that a cash bonus was depletable. The ruling of the Commissioner had theretofore been uniform that these regulations did not apply to cash bonuses, that these were not depletable income but were capital gains. When we turn to Treasury Regulation No. 69,[2] promulgated under the Revenue Act of 1926 and in force when the depletion was taken, we find its language and effect wholly inconsistent with the construction now contended for it, that it relates to or deals with the arbitrary 27½% depletion.

"Nowhere in it is the arbitrary depletion referred to. That is dealt with in Article 221, and no provision is made there for its return. Article 216 in every line of it shows that it is dealing with a situation under which the taxpayer is working on the

[2]Art. 216. Depletion.—Adjustments of accounts based on bonus or advanced royalty. * * *.

(d) "Upon the expiration, termination, or abandonment of the lease, without the removal of any or all of the mineral contemplated by the lease, the lessor shall be required to restore to capital account the excess of the depletion theretofore allowable in respect of the bonus, and royalty payments over the actual depletion or loss in value sustained as a result of the operations under the lease, and a corresponding amount must be returned as income for the year in which the lease expires, terminates, or is abandoned."

cost basis. When such a regulation is sought to be applied to an arbitrary depletion, especially when that has been taken as to a cash bonus, which the Commissioner has all along ruled was not covered by this regulation, the taxpayer finds himself in the position of having paid taxes as on income, on money which was really a return of capital. No matter that the courts have called it a bonus,[3] and having then taken away from him even the small alleviation furnished by the 27½% reduction which under the statute, as construed in the *Herring* case, had been allowed him. I therefore think it plain that the majority opinion has applied Article 216 to this case, when it was not intended to be so applied.

"If, however, I am mistaken in this and it must be considered that the 1926 regulation as interpreted in the 1935 bulletin and the Treasury Regulation 94, promulgated under the 1936 Act,[4] were intended to have application in an arbitrary depletion case, I think it perfectly clear that it is invalid as an attempt to amend or rewrite the Statute to meet the Helvering decision, holding a cash bonus not a return of capital but advance royalty and depletable as such. Since the majority has advanced, as a reason for ruling against the taxpayer, the advantages to the particular taxpayer, of the ruling he contends for, I think I may be par-

[3]Charles Pettit v. Comm., 118 Fed. (2d) 816.

[4]"If for any reason any such mineral lease expires or terminates or is abandoned before the mineral which has been paid for in advance has been extracted and removed, the lessor shall adjust his capital account by restoring thereto the depletion deductions made in prior years on account of royalties on mineral paid for but not removed, and a corresponding amount must be returned as income for the year, in which the lease expires, terminates, or is abandoned."

doned by advancing the unrealities, the unreasonablenesses, the injustices which flow from such an attempt, as stronger arguments against the ruling.

"Under the application of this regulation, as contended for by the majority, these unreasonable results not only may occur, they are certain to. A and B own two adjoining tracts of land. A bought his as agricultural land and for a small price. B bought his as oil land and for a large price. A and B lease their land in the same year. Each received a large cash bonus and a royalty; a great deal more than A's cost, a great deal less than B's, each thinking they had an oil field and that it was to his advantage to do so, take the percentage depletion. A, who has a small cost, is lucky again and has a few dollars of production on his land. B, with his heavy cost, is still out of luck, and has none. Both leases are abandoned in the same year. B, who has a heavy capital investment and has already paid income on cash received which was far less than his investment, is required because he had no production, to pay income on his depletion. A, who has a small capital investment, because he had a small production, is allowed to keep his full depletion. The statute allowing not a cost but an arbitrary depletion was not intended to operate in that way, and the Commissioner cannot, by regulation, make it so operate. It was intended to operate alike by giving all persons who took that method of depletion, the benefit of it without regard to wether they had no, little, or large production. To use the regulation to make it operate differently as between taxpayers, is not to carry out the purpose of the statute, it is by rewriting it, to defeat that purpose.

"I respectfully dissent."

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424954—41

In the Supreme Court of the United States

OCTOBER TERM, 1941

No. 699

TERRY THOMPSON ET AL., INDEPENDENT EXECUTORS OF THE ESTATE OF J. T. SNEED, JR., DECEASED, PETITIONERS

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the United States Board of Tax Appeals (R. 22–35) is reported in 40 B. T. A. 1136. The opinion of the Circuit Court of Appeals (R. 83–90) is reported in 119 F. (2d) 767. Its opinion on petition for rehearing (R. 98–99) is reported in 121 F. (2d) 725.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered May 5, 1941 (R. 90). A petition for rehearing was denied July 17, 1941 (R. 99). The petition for writ of certiorari was filed October 13, 1941. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. Whether where cash bonuses were received by the taxpayer in 1926 for oil and gas leases and a percentage deduction for depletion was allowed with respect to each bonus in computing income for that year, the amount of the allowances may be restored to income in 1936 when the leases expired and were surrendered, no oil or gas having been produced on the properties covered by the leases.

2. Whether where the taxpayer made numerous leases to various lessees covering in the aggregate his entire ranch of 80,000 acres, each tract leased, rather than the ranch as a whole, constituted "the property" the income from which was subject to a percentage allowance for depletion under Section 204 (c) (2) of the Revenue Act of 1926.

STATUTES AND REGULATIONS INVOLVED

The pertinent portions of the statutes and regulations involved are set forth in the Appendix, *infra*, pp. 8–14.

STATEMENT

The facts as found by the Board may be summarized as follows:

The deceased, J. T. Sneed, Jr., was the owner of "Sneed Ranch" consisting of 80,000 acres of land lying in contiguous tracts in the Texas Panhandle Oil and Gas Field (R. 25, 26). In 1926 he made various ten-year commercial oil and gas leases to different individuals and firms, these leases with similar ones theretofore executed covering in the aggregate all of the tracts included within the ranch (R. 25).

Sneed received $210,857.18 in 1926 as cash bonuses for the leases executed that year (R. 25). He reported the bonuses as part of his gross income for the year and, under Section 204 (c) (2) of the Revenue Act of 1926 (Appendix, *infra*, pp. 8–9), claimed deductions for depletion equal to 27½ percent of each bonus received, which were ultimately allowed

after litigation in the Board of Tax Appeals. *Sneed* v. *Commissioner*, 33 B. T. A. 478.

When the leases were made in 1926 there were no oil or gas wells on the tracts involved (R. 25). But the whole of the ranch was regarded as proven oil or gas territory and in the years subsequent to the execution of the leases and prior to 1936 large quantities of oil and some 40 billion cubic feet of gas were taken from various portions of it (R. 25–26). However, on 26 of the tracts, which ranged from 40 to 480 acres in size and were scattered in location, no wells were drilled and no oil or gas was produced (R. 26–27). Accordingly, pursuant to their terms, the 26 leases covering these tracts were surrendered upon their expiration dates in 1936 (R. 26–27).

On account of escape to other tracts and of production on the ranch and elsewhere in the Panhandle Field, the reserves of gas underlying the 26 tracts above mentioned were diminished an average of 11 percent from 1926 to 1936 (R. 27). But commercial quantities of gas remained thereunder and in 1936 after the leases were surrendered Sneed made new leases of the tracts (R. 27). He received cash bonuses in each instance and again was allowed depletion (R. 27).

The bonuses which Sneed received in 1926 on the 26 leases aggregated $120,920.25 and the allowances for depletion $33,528.07 (R. 27). Upon the theory that these allowances should be restored to income, the leases having expired prior to any production under them, the Commissioner included the amount thereof in computing Sneed's gross income for 1936 (R. 24, 27). The Board upheld this action of the Commissioner (R. 29–35). Its decision was affirmed by the court below (R. 90).

ARGUMENT

In *Herring* v. *Commissioner*, 293 U. S. 322, this Court held that production during the taxable year in which cash bonuses are received is not a prerequisite to allowance of the

percentage depletion permitted by Section 204 (c) (2) of the Revenue Act of 1926 (Appendix, *infra*, pp. 8–9). Thus there is no doubt that in 1926 Sneed was entitled to the allowances claimed by him and ultimately granted by the Board.

In its opinion (at p. 328) in the *Herring* case, however, the Court left open the question, here presented, whether the allowances might be treated as income in the year when the leases expire, no oil or gas having been extracted prior to the expiration dates.[1] The Board and the court below answered the question in the affirmative. Although the applicable statutes and regulations are not clear on the point, the interpretation adopted below is, we submit, correct. If the construction urged by the petitioners were adopted, the result would be, in substance, that the benefits of deductions allowed as capital return in anticipation of mineral extraction could be retained notwithstanding that subsequent events proved that there was no extraction and that the deductions represented pure gain.

A. Section 214 (a) of the Revenue Act of 1926 provides for a reasonable depletion allowance to be made under rules and regulations prescribed by the Commissioner, and Section 204 (c) (2) permits computation of the allowance at 27½ percent of the gross income from the property (Appendix, *infra*, pp. 8–9). Article 216 of Regulations 69, promulgated under the 1926 Act (Appendix, *infra*, pp. 11–12) provides in paragraphs (a), (b), (c), and (d) for depletion allowances computed on the basis of cost and for readjustments in capital account in the event of termination, abandonment, or expiration of the lease before removal of any or all the mineral contemplated by the lease. Paragraph (d) specifies that, in such event, "the excess of the depletion theretofore allowable * * * over the actual depletion or loss in value sustained as a result

[1] In view of this fact and of the Court's holding above stated, there is no basis for the petitioners' contention (Pet. 12–13, Br. 44–46) that the decision in the *Herring* case conflicts with that of the court below in the instant case.

of the operations under the lease" shall be restored to capital account, and, in addition, that

> a corresponding amount must be returned as income for the year in which the lease expires, terminates, or is abandoned.

Since these regulations are valid under the statute (see *Murphy Oil Co.* v. *Burnet*, 287 U. S. 299, 303–308) and since similar regulations are contained in Article 23 (m)–10 of Regulations 94 promulgated under the analogous provisions of the Revenue Act of 1936 (Appendix, *infra*, pp. 12–13), there can be no question that the restoration to income in 1936 here involved would have been proper, if the allowances had been taken on the basis of cost, rather than percentage. *Lamont* v. *Commissioner*, 120 F. (2d) 996 (C. C. A. 8).

The petitioners contend (Br. 27–31), however, that the foregoing regulations are inapplicable to percentage depletion and that in no circumstances is it required to be restored to income. This contention is based mainly upon paragraph (e) of Article 216 of Regulations 69, which provides:

> In lieu of the treatment provided for in the above paragraphs the lessor of oil and gas wells may take as a depletion deduction in respect of any bonus, royalties, and other income from the property for the taxable year 27½ percent of the amount thereof, but the deduction shall not exceed 50 percent of the net income (computed without allowance for depletion) from the property.

To construe this language to mean not simply that the lessor may elect to take percentage depletion instead of cost depletion, but that, if he does so elect, he need restore nothing to income upon expiration of the lease without any actual depletion having occurred, would lead to a result never intended by Congress or the Treasury.

In authorizing depletion to be calculated on a percentage basis, Congress permitted a simple method of allowance to be substituted for the complicated previously existing method

of allowance on the basis of cost, but "the nature and the purpose of the allowance is the same in both cases." *Herring* v. *Commissioner*, 293 U. S. 322, 328; *United States* v. *Dakota-Montana Oil Co.*, 288 U. S. 459, 467. Accordingly, in 1935 after the decision in the *Herring* case, the Assistant General Counsel of the Bureau of Internal Revenue issued an opinion concluding that, as in the case of cost depletion, percentage depletion must be deemed to have been taken subject to the condition that it would be restored to income in the year of termination of the lease where there has been no production from the leased premises. G. C. M. 14,448, XIV–1 Cum. Bull. 98, 100–101, Appendix, *infra*, pp. 13–14.

This opinion, which was followed by the court below (R. 88), is not invalid under the general rule invoked by the petitioners (Pet. 8–12, Br. 32–36) that income is taxable only in the year received or in the year when the right to receive it accrues. In cases of cost depletion (*Lamont* v. *Commissioner, supra*) and in many other circumstances, whether or not provided for by regulations, receipts of one year may be treated as income in a later year under statutory definitions of gross income the same as or similar to those contained in the Revenue Act of 1936 (Secs. 22 (a), 41, 42, Appendix, *infra*, pp. 9–10). *Maryland Casualty Co.* v. *United States*, 251 U. S. 342, 353; *Doyle* v. *Commissioner*, 110 F. (2d) 157 (C. C. A. 2), certiorari denied, 311 U. S. 658; *Virginia Iron, Coal & Coke Co.* v. *Commissioner*, 99 F. (2d) 919 (C. C. A. 4), certiorari denied, 307 U. S. 630; and cases cited in the opinion of the court below (R. 89). See *Helvering* v. *Brunn*, 309 U. S. 461. The decision in *Helvering* v. *Schine Chain Theatres*, 121 F. (2d) 948 (C. C. A. 2), is not in conflict with that of the court below since the income there involved should have been taxed in the year received; the only question was whether the taxpayer was estopped to deny liability in the later year. Here it is conceded that Sneed was entitled to the depletion allowances in 1926, subject, however, to the condition above stated.

B. The petitioners contend (Br. 40–44) that Sneed's ranch as a whole was "the property," as meant by Section 204 (c) (2) of the Revenue Act of 1926, in respect of which the percentage depletion was allowed, and that, since there was production on some of the ranch, no portion of the depletion allowed is required to be restored, even if the Government's interpretation of the statutes and regulations otherwise were correct. But Article 221 of Regulations 69 (Appendix, *infra*, p. 12) defines the term as in general referring to "the separate tracts or leases of the taxpayer," and the court below properly ruled (R. 85–86) that each of the 26 leases here involved covered separate property.[2] This Court declined to review an earlier decision to the same effect. *Vinton Petroleum Co.* v. *Commissioner*, 71 F. (2d) 420 (C. C. A. 5th), certiorari denied, 293 U. S. 601, rehearing denied, 293 U. S. 633.

CONCLUSION

The decision of the court below is correct. There is no conflict of decisions. The petition should be denied.

Respectfully submitted.

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NOVEMBER 1941.

[2] The Board (R. 30–33) reached the same result under the definitions contained in Article 23 (m)–1 (j) and (b) of Regulations 94, promulgated under the Revenue Act of 1936.

APPENDIX

Revenue Act of 1926, 44 Stat. 9:

DEDUCTIONS ALLOWED INDIVIDUALS

SEC. 214. (a) In computing net income there shall be allowed as deductions:

* * * * *

(9) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In the case of leases the deduction allowed by this paragraph shall be equitably apportioned between the lessor and lessee;

SEC. 204. * * *

* * * * *

(c) The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the same as is provided in subdivision (a) or (b) for the purpose of determining the gain or loss upon the sale or other disposition of such property, except that—

* * * * *

(2) In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in

no case shall the depletion allowance be less than it would be if computed without reference to this paragraph.

Revenue Act of 1936, 49 Stat. 1648:

SEC. 22. GROSS INCOME.

(a) GENERAL DEFINITION.—"Gross income" includes gains, profits, and income derived from * * * dealings in property * * * and income derived from any source whatever. * * *

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(m) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. * * *

* * * * *

PART IV.—*Accounting Periods and Methods of Accounting.*

SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section

48 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year. (For use of inventories, see section 22 (c).)

SEC. 42. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. In the case of the death of a taxpayer there shall be included in computing net income for the taxable period in which falls the date of his death, amounts accrued up to the date of his death if not otherwise properly includible in respect of such period or a prior period.

* * * * *

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

* * * * *

(b) *Basis for depletion.*—

* * * * *

(3) *Percentage depletion for oil and gas wells.*—In the case of oil and gas wells the allowance for depletion under section 23 (m) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under section 23 (m) be less than it would be if computed without reference to this paragraph.

* * * * *

Treasury Regulations 69, promulgated under the Revenue Act of 1926:

ART. 216. *Depletion—Adjustments of accounts based on bonus or advanced royalty.*—(a) Where a lessor receives a bonus in addition to royalties, there shall be allowed as a depletion deduction in respect of the bonus an amount equal to that proportion of the cost or value of the property on the basic date which the amount of the bonus bears to the sum of the bonus and the royalties expected to be received. Such allowance shall be deducted from the amount remaining to be recovered by the lessor through depletion, and the remainder is recoverable through depletion deductions on the basis of royalties thereafter received.

(b) Where the owner has leased a mineral property for a term of years with a requirement in the lease that the lessee shall extract and pay for, annually, a specified number of tons, or other agreed units of measurement, of such mineral, or shall pay, annually, a specified sum of money which shall be applied in payment of the purchase price or royalty per unit of such mineral whenever the same shall thereafter be extracted and removed from the leased premises, the value in the ground to the lessor, for purposes of depletion, of the number of units so paid for in advance of extraction will constitute an allowable deduction from the gross income of the year in which such payment or payments shall be made; but no deduction for depletion by the lessor shall be claimed or allowed in any subsequent year on account of the extraction or removal in such year of any mineral so paid for in advance and for which deduction has once been made.

(c) If for any reason any such mineral lease shall be terminated or abandoned before the mineral which has been paid for in advance has been extracted and removed, and the lessor repossesses the leased property,

the lessor shall adjust his capital accounts by restoring to the capital sum of the property the depletion deductions made in prior years on account of royalties on mineral paid for but not removed, and his income account shall be adjusted so as to include the amount so restored to capital sum as income of the year such lease is terminated or the property repossessed, and the tax thereon paid.

(d) Upon the expiration, termination, or abandonment of the lease, without the removal of any or all of the mineral contemplated by the lease, the lessor shall be required to restore to capital account the excess of the depletion theretofore allowable in respect of the bonus and royalty payments over the actual depletion or loss in value sustained as a result of the operations under the lease, and a corresponding amount must be returned as income for the year in which the lease expires, terminates, or is abandoned.

(e) [This paragraph is quoted *supra*, p. 5.]

* * * * *

ART. 221. *Depletion in the case of oil and gas wells.*— * * * In general, "the property," as the term is used in section 204 (c) (2) and this article, refers to the separate tracts or leases of the taxpayer.

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

ART. 23 (m)–10. *Depletion—Adjustments of accounts based on bonus or advanced royalty.*—* * *

* * * * *

(c) If for any reason any such mineral lease expires or terminates or is abandoned before the mineral which has been paid for in advance has been extracted and removed, the lessor shall adjust his capital account by restoring thereto the depletion deductions made in prior years on account of royalties on mineral paid for but not removed, and a corresponding amount must be re-

turned as income for the year in which the lease expires, terminates, or is abandoned.

* * * * *

G. C. M. 14,448, XIV–1 Cum. Bull. 98, 100–101 (1935):

* * * * *

In its opinion in *William E. Herring* v. *Commissioner, supra,* the Supreme Court made the statement that it expresses no opinion as to whether the amount allowed as a depletion deduction from the bonus payment in the year of the execution of the lease may be taxed as income to the lessor in the year of the termination of the lease where there has been no extraction of mineral from the leased premises. The allowance of the deduction in the year of the execution of the lease rests upon an anticipation of production to avoid "the attendant inconvenience of indefinite postponement," as was said in *Murphy Oil Co.* v. *Burnet, supra.* The grant of the deduction is in any case upon the ground of "a reasonable allowance for depletion." If on the termination of the lease there has been no production, then there has in fact been no depletion. Ordinarily the Government may recoup only by restoring the deduction to income and asserting the tax against the taxpayer in the year of the termination of the lease. *Cost* depletion on an advance royalty has always been allowed on condition that if the anticipated production does not materialize, the taxpayer will restore the amount of the deduction to income as of the year the lease terminates, expires, or is abandoned. (See article 216 (b) and (c), Regulations 69, with which all prior and subsequent regulations are identical.) Since the "nature and purpose of the allowance is the same," as the Supreme Court has pointed out, whether the deduction be computed on the cost basis or on a percent of the gross income from the property, it follows that the taxpayer must be deemed

to have taken the bonus depletion deduction on the percentage of income basis on the condition that he will restore the amount of such deduction to income as of the year of the termination of the lease where there has been no production from the leased premises.

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